Feasibility Studies

Affinity Group Administrators provides this overview of the Feasibility Study Process and the specific Code requirements at the end to help our clients understand the detailed process and various considerations that must be thoroughly understood when setting up and operating a self-insurance program. Affinity uses experts in various areas to avoid many of the pitfalls described below. While this speaks to captives, the process and considerations are very similar to self-insurance and group self-insurance.

The essence of any feasibility study is the attempt to compare the costs and benefits of forming and operating a captive or self-insurance program with the costs and benefits of the other financing alternatives available.

Parties Performing Feasibility Studies
Internal staff, insurance brokers, captive managers, or independent consultants may perform feasibility studies. Each of these groups brings different strengths, weaknesses, and biases to the process.

Internal staff members are most knowledgeable about the organization considering formation of a captive. Although there is a cost involved when a risk management department performs a feasibility study (i.e., salaries), such costs are almost always lower than if an outside entity were to charge the organization for similar services. However, few internal staffs possess the time, expertise, familiarity with captive market conditions, and knowledge concerning captive service providers to effectively perform feasibility studies without at least some outside assistance. Additionally, risk managers who perform a feasibility study may be biased in favor of a "go" decision because establishing a captive usually enhances risk managers' status within an organization.

Brokers often possess the expertise required to perform feasibility studies effectively. Given their position as middlemen, brokers are frequently knowledgeable regarding market conditions and financing alternatives. Sometimes, they will agree to perform captive feasibility studies for little or no charge. However, brokers cannot be expected to render a truly unbiased opinion about the viability of a captive if they will ultimately be involved in operating or managing the captive in the event that it is formed. Similarly, a broker's objectivity may also be compromised if creation of the captive will cause them to lose commission income because a traditional insurance program will be terminated. Finally, some brokers may object to an insured's forming or joining a captive because this may mean that the broker will have less control over the account, even if the broker's fees or commissions are not significantly reduced by the captive arrangement.

Captive management firms also have an obvious bias with regard to evaluating risk-financing options. Although they are generally knowledgeable, they tend to lean toward a "go" as opposed to a "no go" recommendation in a feasibility study. This is especially true if they will ultimately manage the organization after it is formed. They will also prefer to recommend domiciles in which they maintain offices. Nevertheless, because they are in the business of administering captives on a day-to-day and detail-by-detail basis, captive managers are uniquely qualified to assist firms that are considering this alternative.

Independent consultants who specialize in captive feasibility studies can be highly effective in assessing the potential viability of a proposed captive. However, the fees charged by the most proficient consultants are usually substantial. Additionally, some might use generic or "off-the-shelf" reports that may not adequately address the client's specific problem yet for which significant research and development costs are built into their fee. They may also be inclined toward a "go" decision if formation of the captive presents the possibility of additional consulting engagements once the captive has been formed.

At the outset of a feasibility study, it is usually best if the entity performing the analysis is advised that it will not manage the captive in the event it is created. This helps to assure that the broker, manager, or consultant has no stake in either recommendation, thereby assuring the most unbiased assessment possible.

Time, Cost, and Information Required
Numerous variables enter into determining how much time and money will be required to complete a feasibility study. Depending on the complexity of the exposure, captive feasibility studies can take up to a year to complete, and can cost in excess of $100,000 in some cases.

It is interesting to note that the information required to perform a captive feasibility study is similar to what is required when submitting specifications for bidding an organization's insurance program.
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Data Required For A Feasibility Study

- A detailed description of the organization's current insurance program that lists all coverages, limits, retentions, insurers, and policy dates
- Description of the organization's operations and products, including an annual report, a statement of corporate long-range plans for expansion into new products, locations, and proposed acquisitions or divestitures
- Current financial information (e.g., balance sheet, income statement, 10K report, budget—if a governmental entity or nonprofit organization)
- The projected workers' compensation experience modification factor
- Accurate loss history for at least the past 5 years, including detailed descriptions of large losses (e.g., those exceeding $25,000)
- Historical and projected exposure data for the coverages involved in the proposed captive (e.g., payrolls, sales, fleet size, location schedules and statements of value, square footages of premises, employee counts). At least 5 years of historical data is usually required.
- The organization's projected income tax rate
- The organization's interest rate assumptions

Sometimes the data-gathering process of a feasibility study consumes the majority of the time spent in determining whether the proposed captive is viable. Consequently, it is critical for the organization's internal staff to provide the individuals performing the feasibility study with this information in a well-organized, intelligible fashion. Significant amounts of time and money can be saved if this phase of the project is performed expeditiously.

Steps in the Feasibility Study Process

The analysis proceeds to identify and analyze the exposures, forecast losses, determine an optimal retention level, identify alternative financing methods, estimate costs under each of these alternative financing methods, initiate the financial modeling process (i.e., preparing projected income statements and balance sheets), and finally, select a single "best" alternative from among the options that have been identified and evaluated.

Exposure identification and analysis requires the consultant performing the feasibility study to evaluate both known sources of loss (i.e., causes of previous claims) as well as potential causes of loss for the coverage lines that the captive intends to write.

Based on previous claim frequency and severity, as well as anticipated changes in the nature of the exposure to be insured, the next step in the process is to forecast losses for the coming year.

The loss forecast is then used to perform a retention analysis, the purpose of which is to determine the optimal level of loss (both per claim and annual aggregate) that should be assumed by the captive, prior to reinsuring excess amounts. "Optimal," in this case, refers to the point at which the total of retained losses plus reinsurance premiums are minimized, based on anticipated losses and expected reinsurance costs.

It must again be stressed that feasibility studies should always include a thorough examination of risk financing alternatives in addition to forming a captive. Indeed, a captive can only be considered "feasible" if other methods of financing the exposure are "less feasible." Accordingly, the consultant should also explore mechanisms including, but not limited to, the following:

- Conventional loss sensitive insurance programs
- Self-insurance/self-insurance pools
- Risk securitization or finite reinsurance
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Moreover, organizations should not make the mistake of comparing the costs of the proposed captive to their current program because a better non-captive alternative may be available. Therefore, each of these different options should be evaluated and compared.

Assuming that captive insurance proves to be an option that has some merit, the final step in the feasibility study is to prepare projected income statements and balance sheets for the proposed captive, usually covering a 5-year period (both before and after tax), an exercise otherwise known as "financial modeling." With estimates of the rate of return on the capital that would be invested in a captive, the consultant and the organization are in a better position to judge the viability of the venture. It must be recognized, however, that these projections are always heavily dependent on the state of the insurance market during the succeeding 5 years. Any unexpected, radical shift in the overall level of commercial insurance premiums can significantly affect the accuracy of such projections.

Intangible Benefits of Feasibility Studies
Even a "no-go" decision at the conclusion of a feasibility study can benefit an organization. Often the "threat" of a captive will induce the firm's agents/brokers and insurers to render higher levels of service and even lower fees or premiums in future renewals (depending on market conditions). Additionally, the rigors of the feasibility study process typically require that an organization take a careful, detailed, and honest look at its risk management and insurance program. This exercise usually produces substantial benefits even if the process does not ultimately result in forming or joining a captive.

"Alternative" Feasibility Studies
One alternative to the traditional feasibility study is to simply obtain quotations from the marketplace for the services that will be required by the captive. In other words, rather than performing the detailed analyses of the typical feasibility study, insureds should immediately ascertain the probable costs of fronting, reinsurance, claims, loss control, legal, management, accounting, and other requisite captive services. At that point, such costs should then be compared to non-captive risk financing alternatives. The logic of this approach lies in the fact that for most insureds, the viability (or lack thereof) of a captive is usually apparent very early in the feasibility process. When this is the case, the study can be abandoned, or the organization can proceed to the implementation phase before the feasibility study is completed. This approach has the advantages of saving both time and money when, at the outset, a captive clearly appears to be a viable alternative.

More specifically, by putting together "first approximations" of costs without performing detailed analysis, it can quickly be determined if quotations for specific items should or should not be obtained.

Such approximations do not assess potential savings inherent in other types of programs (e.g., self-insurance, retrospectively rated plans). Nor do they consider the possible financial effect of the "heavy" loss scenario, whereby losses exceed the apparent savings. Nevertheless, they do indicate at the outset whether the time and effort required by a full-blown feasibility study is even warranted. Or, in the alternative, "first approximations" could demonstrate that quotations should be immediately sought because a detailed feasibility study will result in a clear-cut "go" decision.
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The State of California Requirements are as follows:

§15471. Initial Feasibility Study.

(a) Accompanying each group self insurer's initial application for a Certificate To Self Insure required by Section 15203 of these regulations, shall also be an feasibility study prepared by an independent risk management individual or firm addressing all of the following:

(1) The advantages and disadvantages of group self insurance for the proposed group members as compared to the options of individual self-insurance, or coverage under a policy issued by a carrier(s);

(2) Identification of all proposed group members and the combined total payroll for the proposed group self insurer;

(3) A consolidated summary of the historical workers' compensation claims loss experience and the allocated loss expenses of the proposed group members for the three most recent, completed, full policy years, as well as, the current partially completed policy year to the most current quarter under the current policy;

(4) An evaluation of the historical workers' compensation claims costs for the group members and actuarial projection of the expected claims costs for the first five years of the group operation. The actuarial projection to be prepared by (A) an independent person with a designation of Fellow of the Casualty Actuarial Society (FCAS); or (B) by a member of the American Academy of Actuaries (MAAA) with current experience in making California workers' compensation actuarial projections.

(5) A five year proforma financial statement including, as a minimum, an income statement, balance sheet, projected cash flows, and claims payout projections. The proforma financial statement must include a detailed separation of assets, liabilities, retained earnings, taxes, and dividends. If any claims costs are discounted, the interest rate assumptions and payout patterns must be described and based on reasonable assumptions. The claims payout schedule shall be calculated using the 80th percent confidence level figures from the actuarial study.

(6) A summary of the specific details of the group self-insurer's operating plan including, but not limited to:

(A) The legal and organizational structure;

(B) Method of governance;

(C) General management of the pool, including underwriting policies, insurance coverage, billing, etc.

(D) Rating plans or premiums or other means by which group funding during the first five years of operation will generated and the amounts to be generated by the methods proposed for each of the first 5 years of operation;

(7) The first 12 month budget of the group self insurer;

(8) Excess Insurance Coverage including estimated cost, attachment point of specific excess coverage policy and aggregate excess policy (if any), and maximum liability of each excess policy;

(9) Summary of the third party claims administration agency chosen to handle the group self insurer's claims;

(10) Safety and loss control services that will be available from the group self insurer to group members;

(11) Underwriting requirements for initial and subsequent member selection into the group self insurer, including particular emphasis as to whether any underwriting requirement would be excluded from coverage by the specific excess or aggregate excess insurance coverage;

(12) Name of certified public accountant that will prepare annual financial reports for the group self insurer;
(13) Name of actuary and their professional actuarial designation who will prepare actuarial reports for the group self insurer and the frequency of such evaluation reports;

(14) Means by which the group self insurer will post the required security deposit and how that cost or deposit will be allocated to the group members;

(15) Any fidelity coverage and errors and omissions coverage that will be maintained by the group;